REPORT

OF THE GOVERNANCE ADVISORY PANEL

TO THE

EXECUTIVE COMMITTEE

AND THE

BOARD OF GOVERNORS

OF

THE NATURE CONSERVANCY

MARCH 19, 2004

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Introduction

On June 13, 2003, following a series of stories in *The Washington Post*, the Board of Governors of The Nature Conservancy announced a number of substantive changes it would make in its programs, focusing on five areas: conservation buyer transactions; cause-related marketing partnerships; resource extraction activities on Conservancy-owned lands; loans to employees; and related-party transactions. The lengthy discussion of the June 13 changes ended with these sentences:

". . . the Board decided today to enlist outside perspective and expertise to help the organization continue to strengthen its governance, transparency and accountability. In the very near future, the Board will determine the exact scope and time frame of this process and announce the participants."

By mid-August the undersigned had agreed to serve as TNC's Governance Advisory Panel. We began our discussions and operations in late August with extensive meetings involving the current and incoming TNC Board of Governors Chairs, as well as its President, followed by extensive meetings in Arlington with TNC senior staff.

In its September 29, 2003 press release formally announcing the Panel, TNC stated its goal was to become "a recognized non-profit sector leader in the areas of governance, transparency, and accountability" and that it hoped "the Panel's recommendations will be of great value to the Conservancy specifically, and the non-profit sector more broadly."

A paper -- "Work of Outside Advisors on Key Issues" -- prepared by the Board of Governors for the Panel asked it to make a preliminary report to the Board at its January 2004 meeting, followed by the Panel's final report in March 2004 which would make detailed recommendations on governance, transparency, and accountability. The paper is annexed to this Report as Appendix A.

A Board Liaison Committee was appointed, consisting of Roger Milliken, Jr., John P. Morgridge, Admiral Joseph W. Prueher, John P. Sall, and Christine M. Scott, who served along with then-Chair Anthony P. Grassi, the incoming Chair, Carol E. Dinkins, and Henry M. Paulson, Jr., who was later elected Chair after Ms. Dinkins resigned for reasons of health. The Panel and the Board Liaison Committee met on September 24, followed by a session with the senior staff of TNC at its Arlington headquarters on September 25.

Following the Arlington meeting, the Panelists began a series of meetings and interviews, as well as frequent telephonic discussions. Beginning on November 5 and ending just prior to the Panel's meeting with the Board of Governors on January 28 and 29, 2004, the Panel met on five separate occasions. The usual format consisted of an executive session in the morning, followed by a working lunch with members of the Board Liaison Committee, ending with a second executive session in the afternoon.

As requested by the Board in the September press release, the Panel made its initial recommendations at the Board meeting on January 28, 2004 in Arlington. The memorandum accompanying the January 28 recommendations noted that the Panel's efforts with respect to the Board were now nearing completion, and that it therefore intended to complete its assignment by focusing on TNC's local chapters as well as assisting TNC's new Chair in his efforts to examine TNC's programs from the standpoint of transparency and accountability. The Panel was very pleased that independently of its efforts, Chair Paulson had already begun, at a lengthy meeting on January 9, intensive efforts to study each of the programmatic areas in question, and recommend appropriate changes as necessary with special emphasis on risk and reputation.

The Panel was not established to investigate past practices, but it necessarily had to become aware of them in order to make its recommendations. Accordingly, when the Panel turned its attention to the issues discussed in Part III, it did so recognizing that those issues were within the province of the newly restructured Board. The Panel notes that the Board and senior staff have already made important changes to TNC processes and procedures, and that the process of review and change is fluid and continuing under the Board's supervision. The Panel's discussion in Part III, therefore, is general and intended to be of guidance.

The Panel compliments Chair Paulson, the Board, and the senior staff on the speed and diligence with which they are evolving TNC -- it bodes well for the future.

Since the Panel began its work last year, it has spoken often and at length with a number of people who have been extremely helpful in assisting Panel Members with their deliberations, in addition to extensive interviews with TNC volunteers and staff at all levels, including, of course, Chairs Grassi, Dinkins, and Paulson, and the President and his staff at TNC's world headquarters, all of whom cooperated fully with the Panel and provided the Panel with full and free access to TNC.

The Panel also wishes to express its appreciation for the time and counsel the following individuals provided: Bob Ackerman, Chapter Chair, Massachusetts; Graham Chisholm, State Director, California; Bryant Danner, Trustee, California; Dennis Fitzpatrick, Chapter Chair, Idaho; Tom Harville, Chapter Chair, Washington; Wayne Klockner, State Director, Massachusetts; Geoff Pampush, State Director, Idaho; Wendy Paulson, outgoing Chapter Chair, New York; Jan Portman, Member, Board of Governors; Roy Rogers, Chapter Chair, Florida; Alan Seelenfreund, Trustee, California; Henry Tepper, State Director, New York; Vicki Tschinkel, State Director, Florida; and David Weekes, State Director, Washington.

In a similar fashion, the Panel wishes to thank Milton Cerny, former Chief of Exempt Organizations Rulings of the IRS and Member, Caplin & Drysdale, Washington, D.C.; Jay Erickson, Managing Director, Montana Land Reliance; William Josephson, Assistant Attorney General, Charities Bureau, New York State; Karin Kunstler Goldman, Registration Section Chief, Office of the Assistant Attorney General, Charities Bureau, New York State; Marcus S. Owens, former Director of the Exempt Organizations Division of the IRS and Member, Caplin & Drysdale; Rock Ringling, Managing Director, Montana Land Reliance; Jonathan Selib, Democratic Staff Member, U.S. Senate Finance Committee; Stephen J. Small, Esq., Boston, Massachusetts, and former attorney in the Office of Chief Counsel of the IRS; Mark S. Weston, Real Estate Consultant and Appraiser, Hunsperger & Weston, Greenwood Village, Colorado; Douglas Varley, Member, Caplin & Drysdale; and Dean Zerbe, Chief Investigative Counsel, U.S. Senate Finance Committee.

Finally, the Panel wishes to thank David B. Hird, John A. Neuwirth, and Robert C. Odle, Jr. of Weil, Gotshal & Manges LLP for their invaluable assistance in gathering information and organizing the work of the Panel.

Ira M. Millstein, Chair

Derek C. Bok

Claudine B. Malone

Richard T. Schlosberg III

Thomas J. Tierney

I. The Board

The past years have witnessed a dramatic shift in public expectations regarding the accountability of private organizations and the responsibilities of their governing boards. This has involved highly publicized scandals at large for-profit corporations, and media and U.S. Government attention to philanthropic and other non-profit entities. *The Washington Post* series on The Nature Conservancy is illustrative of the trend, but there have been similar reporting and editorial comment in newspapers and magazines throughout the nation. This process is likely to accelerate as Congress examines the manner in which the tax code is currently used by non-profit organizations.

These developments promise to bring new pressures to bear on non-profit boards to become more informed and more active in overseeing their operations. Faced with this changing environment, the Governance Advisory Panel offered a preliminary proposal to TNC's Board of Governors on January 28, 2004. Following a series of lengthy, interactive, and productive meetings with the Board's Liaison Committee; it attempted to outline how TNC might initiate changes at the Board level in its structure and functioning to help it respond more proactively to the challenges that currently confront it. The Board of Governors adopted this proposal at its meeting on January 29, 2004, and since that time, refinements have been incorporated based on comments from TNC officials and others.

The Panel believes that a central issue of board governance is ensuring that the board serves as an active and objective body for monitoring management activities. Because non-profits receive private donations and public benefits, it is essential that a non-profit board ensure that managers use organizational assets for their intended purpose, and scrupulously operate in a transparent, lawful, and ethical manner.

Board duties should include:

- Articulating expectations and standards related to organizational culture and the "tone at the top";
- Establishing the basic policies of TNC and reviewing any proposed deviations from them;
- Selecting, monitoring, evaluating, compensating, and if necessary, replacing the president, and in some circumstances, senior staff;
- Reviewing and approving management's strategic and programmatic plans (consistent with the non-profit mission) and monitoring performance against the strategic and programmatic plans to evaluate whether the organization is being properly managed;
- Reviewing and approving the organization's financial objectives and major plans and actions;

- Reviewing and approving significant transactions;
- Reviewing and approving the auditing and accounting principles and practices used in preparing the organization's financial statements;
- Providing oversight of disclosure and transparency, risk assessment, internal controls, and processes designed to promote legal and ethical compliance; and
- Assessing the board's own effectiveness.

It is in this spirit that the following has been formulated:

A. The current Board of Governors ("BOG") would select the Members of a new Executive Committee ("EC") to consist of the Chair, two Vice Chairs, President, Secretary/Treasurer, and the Chairs of six Committees, for a total of eleven Members of the new EC. The Chair and the two Vice Chairs would each inform themselves as to the activities of two Committees and would each act as liaison to two committees.

B. The Committees would consist of approximately five Members each, would be drawn from the entire membership of the BOG, and would meet at least quarterly. The Governance Committee would lead the process by which Members of the BOG are assigned to Committees. The President would not serve on Committees. Because each BOG Member would make a serious and significant commitment of time to Committee work, to the extent practical no one would be expected to serve on more than one Committee, although the Chair could attend any Committee meeting ex officio, as could the President, unless excused by the Members of the Committee. Written charters stressing each Committee's accountability for its missions would be prepared by each Committee, and reviewed annually for submission to the Governance Committee, and then to the EC and the BOG. The Vice Chairs of each Committee, who would serve on the BOG but not on the EC, would be responsible for each Committee's liaison efforts with local chapters. Further, while it is inevitable that the work of one Committee may overlap with that of another, such overlap is not necessarily undesirable.

The Committees would be:

(1) Audit:

- Normal audit functions (retain, evaluate, and work with outside auditors; internal audit function)
- Financial Reporting and Regulatory Reporting
- Compliance (ensuring procedures support policies and monitor compliance with procedures)
- Legal (address broad legal issues that have ramifications across TNC)
- Ethics (compliance with organization's values and code of conduct, including whistleblower issues)

- Compliance with lobbying regulations
- Conflicts of interest

N.B.: At some point in the future, the EC might shift certain of these assignments to other Committees if they result in precluding the Audit Committee from a sharp focus on basic Audit Committee tasks.

(2) Strategy:

- Mission, Strategy, Values
- Strategic and Annual Planning
  - Science, including annual "Science Audit"
  - Measures and Results
  - Public Policy and Government Relations

(3) Governance:

- Nominating
- Orientation
- Board and Committee Self Assessment
- Volunteer Leadership
  - Role of state/country volunteer leaders
  - Relationship of trustees and BOG in governance
  - Engagement of state/country volunteers to maximize influence and reach
  - Standards, Best Practices, and BOG Guidelines
- Human Resources
- CEO evaluation and succession
- Compensation

(4) Conservation Project Review:

N.B.: The purpose of this Committee would be to ensure adequate oversight and risk management of TNC's conservation programs, with a particular emphasis on large or novel conservation projects -- i.e., high-dollar value conservation buyer transactions and transactions with government entities, compatible human use activities, etc. Other functions of this Committee would include:

- Strategic fit/conservation, return on investment
- Risk assessment and management (financial, reputational, legal, and ethical)
- Easements (valuation, monitoring, amendments, enforcement, conservation value)
- Scientific rationale

(5) Finance:

- Investment policy and oversight
- Budgeting
- Long-term financial planning
- Financial status
- Performance benchmarks

(6) Marketing and Philanthropy:

- Donor Relations
- Fundraising Strategy and Results
  - Membership
  - Annual Funding
  - Capital Funding
- Fundraising Efficiency
- Communications
  - Marketing
  - Public Relations

C. It would be important for some of the EC Members to be persons who are not current Members of the BOG. This would be accomplished as soon as reasonably possible. All BOG Members would participate in an extensive orientation course and the Governance Committee would regularly review BOG Member performance. Over time, some Members who leave the BOG would not be replaced so that the size of the BOG did not increase beyond its current size due to the fact that any person elected to the EC would automatically become a member of the BOG.

D. Members of the BOG and EC would be independent of TNC pursuant to standards to be established, but at a minimum, no Member of the EC could hold any other TNC position, except for that of President. It would be, however, desirable if some Members of the EC had previously served as trustees.

E. TNC financial supporters would be eligible for election as BOG and EC Members, but no Member or his/her company could take an income tax deduction for any gift of land to TNC nor could any Member or his/her company purchase land from or sell land or easements to TNC while serving as a Member. Monetary gifts would of course be welcomed but Members and their companies would not be permitted to have cause-related marketing agreements with TNC.

F. While BOG and EC Members would not be chosen to represent TNC "constituencies," selecting Members who have expertise and competency in various areas in addition to conservation and the environment would be strongly encouraged, especially in governance, but also in other areas such as international affairs, ethics, audit and accounting, finance and investment, tax policy, conservation science, public and governmental affairs, real estate, law, etc.

G. BOG and EC Members would be elected for staggered three-year terms. Members would be eligible to serve two consecutive three-year terms, and would be eligible for election again one year after serving two consecutive three-year terms.

H. The EC would have in-person meetings at least quarterly. The EC and the Committees could and would meet telephonically between regular meetings. The BOG would meet two or three times a year, and could meet telephonically. Other than the President, BOG and EC Members would not be compensated.

I. The Chair would be responsible for the development of the agenda for each EC meeting. The outside EC Members would devote a portion of each meeting to a session which would not include the President.

J. An independent, outside auditor and the Director of Internal Audit would be appointed by the EC annually upon the recommendation of the Audit Committee and would report to the Audit Committee. The fees for the outside auditor would be set by the Audit Committee. The Audit Committee would decide no less frequently than every five years whether a new outside auditor should be selected, and if the then-current auditor is retained, a new lead partner would be selected. The General Counsel and a new Compliance Director would be selected by the President, subject to the prior approval of the EC. The Internal Audit Director's position description would be expanded to include responsibilities similar to those in U.S. Government departments held by Inspectors General, i.e., an internal investigatory function. The General Counsel and the new Compliance Director would report directly to the EC as well as to the President. Annual audits of legal issues and science programs would be performed.

K. In the interest of accountability to the internal and external and numerous and varied constituencies that have an interest in TNC, a major focus of the EC would be the promotion of transparency in all facets of TNC's governance, businesses, programs, and performance, including oversight of all mandatory and discretionary reporting.

L. The new structure would be phased in as soon as possible. Thereafter, the EC would develop formal elaborated guidelines for its future operation and conduct. These guidelines would include, among other things, Committee charters more particularly specifying the respective responsibilities and organization of each of the Committees (including the EC). A draft Audit Committee Charter is annexed to this Report as Appendix B.

II. The Field

The Panel has focused on TNC's local chapters because it believes that great and enduring enterprises are built around a robust core that defines and drives an institution. In TNC's case, that core is represented by its local chapters. For decades, relatively independent field operations have worked to conserve land, develop membership, engage local trustees, and generate significant financial support – primarily within the boundaries of their separate geographies. The unparalleled success of these chapters sets TNC apart from other conservation organizations, and provides an opportunity for TNC to impact ecosystems throughout the world.

Despite the grassroots nature of the chapters, TNC is organized as a single non-profit entity, reflecting the inherent interdependence of local organizations pursuing a regional, national, and global mission. The operating implications of Conservation by Design, TNC's overarching strategic framework, amplify this interdependence, as does the imperative to minimize organization-wide risk in an era of increasing public scrutiny.

If local chapters are primarily accountable for pursuing TNC's strategy within their boundaries, then the BOG and EC will ultimately be accountable for insuring that the whole is greater than the sum of the parts; that is, enhancing the overall long-term success of the mission, while mitigating its inherent risks. Because TNC is fundamentally chapter-driven, its world headquarters is highly dependent upon the behavior of the chapters – and vice versa. Given TNC's strategy and circumstances, there can only be shared accountability for future outcomes. And because the reputation of each chapter is affected in today's world by the behavior of other chapters, all chapters have a stake in an effective system of standards and accountability administered nationally and coordinated with the field.

The issues of governance, accountability and transparency are complicated for TNC due to its chapter structure. There are currently fifty-five relatively independent chapters in the U.S., each with its own board of local trustees. Although these boards have no real fiduciary responsibility, they are, in practice, highly engaged in the strategy and operations of the chapters. Their activities range from reviewing land transactions, fundraising, approving budgets, advising local staff on various management issues, and actively participating in the hiring of the State Director. Some trustees have served in this role for many years, while others are new to TNC. As a group they number approximately 1,500 and represent an essential asset in pursuit of TNC's mission to preserve the world's last great places.

TNC's historic growth and success can be traced directly back to the achievements of these chapters. What began in 1951 as a local effort in New York State to preserve parcels of land grew to encompass twenty state chapters by 1975. In the following decades, grass roots efforts were supplemented by a more proactive strategy as TNC expanded internationally in places such as South and Central America, the Caribbean, the Pacific Rim, Canada, and China. TNC's ability to blend strong local presence with centralized leadership and collaboration has been essential in protecting ecosystems that naturally transcend state and regional boundaries. Nevertheless, to the broad range of members, TNC has been very much "placed based," with particular enthusiasm centered on projects which are generally close to home. It is a great strength of the organization that so many members think of it as "my TNC."

This organizational approach also explains why TNC is structured as a single 501(c)(3) entity. The Panel examined other large geographically diverse charities and found that most are organized as a "federation" of separate legal entities (examples include: The United Way, Habitat for Humanity, Catholic Charities, and the Boy Scouts of America). Although this federation approach may help clarify the accountability and role of local directors, there is no evidence that it significantly improves overall governance of the entity.

On balance, the Panel is convinced that TNC's local chapters form the fundamental core of TNC's operations, and that those chapters should continue to be integrated within the boundaries of a single 501(c)(3) entity.

In that context, the Panel evaluated actual governance practices of a cross section of TNC chapters. We found the local trustees to be extremely competent, highly engaged and committed to TNC's success, and in general agreement about TNC's overall strategic direction. "Conservation by Design" had wide support among local trustees and staff. That said, the inherently grass roots and independent nature of the chapters led to many inconsistencies relating to governance practices. No single inconsistency was particularly alarming; in general, chapter trustees are well organized and productive. However, there were a number of variations around the exact role of the individual trustees, the structure and functioning of local "boards", the application of by-laws, and the participation in local decision-making (both strategic and operational).

Given our recommendations concerning TNC's Board, and our understanding of local chapter governance within TNC, the Panel proposes three areas for improvement:

- Establish minimum uniform governance standards for each chapter trustee board;
- Clarify decision making roles and responsibilities between the BOG, EC, local chapter boards, and senior staff, especially as pertains to land transactions and strategic decisions; and
- Enhance transparency and communication between the BOG, EC, and chapter trustees and staff.

We briefly elaborate on each of these recommendations below:

A. <u>Governance Standards for Chapter Boards</u>

Minimum standards should build upon a combination of historic best practices and the restructuring of the Board. The following areas should be addressed:

- Committee structure, membership, and charters
- Audit and evaluation practices
- Eligibility and participation requirements for chapter trustees
- Terms and term limits
- Minimum meeting requirements
- Reporting requirements
- A trustee orientation/training program

This process should produce an updated set of chapter by-laws and a process for evaluating compliance across all TNC chapters.

B. Decision-Making Roles and Responsibilities

While TNC should continue to promote innovation and entrepreneurship by the chapter boards, the Panel believes that ultimate authority should remain with the BOG and the EC, which are responsible for supervising the actions of the chapter boards and reviewing their decisions.

The Panel believes that chapter boards should review and ratify the most important decisions confronting local chapters, subject to the ultimate authority and oversight of the BOG and the EC. These decisions should parallel the types of decision made at the BOG and EC level as well as the standards for making such decisions, and would likely fall in the following categories:

- Chapter strategy, particularly its alignment with TNC's overall strategy
- Operations: e.g., approval of annual budgets, hiring targets, financial plans, fundraising practices
- Land transactions: e.g., any and all potentially "high risk" transactions
- Compliance with policies and procedures: e.g., TNC-wide policies requiring chapter compliance such as conflict of interest

By specifying that certain decisions must be debated and approved by chapter boards, TNC will encourage accountability of local leadership, improve the quality of its decisions, and enhance its ability to effectively govern its complex organization. And, of course, significant decisions of chapter boards must be subject to review by world headquarters to insure consistency.

C. Transparency and Communication

Given the need for greater coordination and integration between the BOG, EC, and chapter trustees, it is the Panel's recommendation that TNC identify mechanisms to insure better transparency and communication among the various leadership groups. While current practices are admirable, they fall short given the growth of TNC, the dynamics of its environment and the new pressures surrounding non-profit boards to be more diligent in the oversight and evaluation of operations. At least in the short term, TNC should do its best to over-communicate regarding any significant issues, initiatives or decisions.

Of course, there are inherent tensions between the center and its constituent parts in every organization with strong local units; this can best be minimized through ample coordination and exchange of information.

These three sets of recommendations around chapter governance standards, decision-making, and communication are intended to complement the Panel's recommended modifications to the Board, while reinforcing the changes to policies and procedures that have and will be made.

These recommendations regarding the functions of the chapters and their interaction with world headquarters are key to the future credibility and efficiency of TNC. Implementation of these necessarily generic recommendations obviously will take a great deal of time, goodwill, effort, and forthright communication.

The EC must assume this responsibility promptly, and with special effort, in the hope that within a reasonable time concrete policies and processes will be in place that adhere to these general principles.

III. Programs, Transparency, and Accountability

In addition to recommendations concerning the issues addressed in Parts I and II of this Report, the Panel's charter also requests recommendations on ways to improve and enhance TNC's transparency and accountability, particularly as these issues relate to TNC's programs and policies.

Progress continues with steps taken by TNC's new chairman, Henry M. Paulson, Jr., and by the senior staff. Shortly after his election, Mr. Paulson convened on January 9, 2004, an "issues meeting" of TNC senior staff members to discuss proposed changes to, and risks posed by, TNC's policies relating to conflicts of interest, easements, land transactions with government, project review, compatible human use, and compensation. This ongoing process of review and change at TNC is comprehensively documented in a February 12, 2004 memorandum prepared by TNC Managing Director of External Affairs, Michael Coda, entitled "Processes for Managing Reputational Risks" (the "Memo"). The Panel believes the Memo represents a substantial effort by TNC's senior staff to develop policies and practices to address many of the key issues of transparency and accountability facing TNC. The Panel notes that the Memo has undergone a series of revisions reflecting the progress TNC is making with regard to the identification of issues and appropriate ways to address these issues.

Given the ongoing modifications that TNC is making in these areas, and as discussed in the Introduction, the Panel's comments are necessarily general.

A. Valuations and Appraisals in Land Donations and Conservation Easements

Land donations and conservation easements play a critical role in TNC's mission. For many years, TNC has appropriately measured the success of its efforts in terms of the number of acres of ecologically sensitive land held in fee or controlled through easements.

Clearly, the availability of a federal tax deduction is a major incentive for donors to contribute land or easements to TNC. Although current law requires TNC, as the donee organization, to acknowledge receipt of the gift on IRS Form 8283, it does not require that TNC take a position on the value of the gift. In the past, TNC's policies have been consistent with the law: TNC would not take a position on the value or deductibility of any easement or gift of land; TNC would undertake its own appraisals usually for the purpose of determining whether the sale price which TNC paid or received for land or easements were supported, but not to determine the propriety of the donor's appraisal.

Recently, however, concerns have been raised -- also appropriately -- about the validity of appraisals used to support the claims for tax deductions made by donors of land and easements to non-profits. Given the understandable concerns about valuations and donor contributions to non-profits, the Panel recommends that TNC put in place careful, systematic, and strict procedures that will ensure compliance with all aspects of the spirit and letter of the rules for charitable contributions of conservation donations, with particular emphasis on appraisals and other elements of valuation substantiation of such gifts.

The Panel applauds the recommendations of the senior staff in the Memo which propose that TNC refuse to sign a Form 8283 unless the donor's appraiser is state-certified, not barred from practicing before the IRS, and has experience appraising conservation lands and easements. The Memo also recommends that TNC determine that the appraiser uses generally accepted professional appraisal standards, accounts for the enhancement to any neighboring property owned by the donor, and certifies his or her awareness of any conflict of interest. The Panel considers these recommendations to be important steps in the right direction.

The Panel suggests that potential donors be informed at the outset of the transaction that TNC will closely examine the qualifications of the appraiser, the methods used, and the appraisal itself.[1]

In addition, the Panel recommends that TNC undertake a "desk review" of all aspects of a proposed conservation transaction, which would include a review of the donor's appraisal, to determine whether the transaction is appropriate.

The Panel believes that TNC must demonstrate that it is willing to "walk away" from an otherwise advantageous transaction where all aspects of the transaction do not meet TNC's new standards, including where a donor wishes to claim a tax deduction based on an appraisal that is not justified.

Finally, the Panel notes that the Memo (at p. 24) recommends training in TNC compliance policies, which the Panel certainly encourages; the Panel recommends that such training be expanded to cover tax issues relevant to both TNC and donors. The Panel also suggests that TNC encourage law and business schools to include these subjects in courses.

B. Monitoring and Enforcement of Easements

A closely related issue is the monitoring and enforcement of easements. The conservation value of easements could be undermined if property owners do not comply with the terms. Moreover, adequate monitoring and enforcement of easements is critical to achieving long-term conservation results. The Panel believes that TNC should regularly monitor compliance with easements, should require property owners to disclose plans for changes in easements, and take rigorous enforcement action where landowners act inconsistently with easement terms.

TNC recognizes these concerns, and in addition to the easement policy it adopted in 2001, the Memo (at pp. 22-23) sets forth several proposals for ensuring more effective monitoring and enforcement of conservation easements. The Panel recommends that TNC's General Counsel and its Compliance Director take steps to implement programs to enforce the easement amendment policy and take aggressive action, where appropriate, against land owners who infringe upon easements.

[1] TNC should consider whether the review of the donor's appraisal could take place at the time the gift is made, not after the fact when the Form 8283 is submitted. Because the Form 8283 need not be completed before the donor files a tax return, it may not be submitted for many months (especially if the taxpayer seeks an extension of the filing date) after the end of the calendar year in which the donation was made.

C. Conflicts of Interest

At TNC's June 2003 Board of Governors meeting, the Board modified TNC's conflicts of interest policy to prohibit the purchase or sale of land, easements or any other interests in land involving members of the Board, trustees and employees (and their immediate families). In addition, the Board made clear that parties entering into land transactions with TNC must be unrelated to TNC for a minimum of one year before entering into a land transaction.

Following these changes, at the January 29, 2004 Board of Governors meeting, the Board adopted the Panel's Proposal requiring that no member of the Board or Executive Committee of the Board (or his or her company) (i) take an income tax deduction for any gift of land to TNC; (ii) purchase land from, or sell land or easements to, TNC; or (iii) have a cause-related marketing agreement with TNC.

Additional improvements to TNC's conflicts of interest policy are comprehensively set forth in the Memo, including one that "major donors" be considered "covered persons" and, thus, subject to the policy. The Panel understands that TNC is in the process of redefining the term "major donor" for purposes of conflict of interest analysis to include anyone who donated cash or assets worth $100,000 or more in the aggregate during the five years prior to the transaction.

It is especially important that the Audit Committee remain actively involved in overseeing and monitoring TNC's policies and procedures with respect to conflicts of interest, and that TNC's conflicts of interest policy be transparent (i.e., clearly articulated in TNC's Form 990 which would, in turn, be posted on its website).[2]

D. Transactions with Governmental Entities: the "No Net Profit" Policy

The Panel believes that it is important for TNC's reputation that not only it comply with its "No Net Profit" policy, but also be able to document that compliance in a transparent manner.

The Panel recommends that the "No Net Profit" policy be fully disclosed on its Form 990. In order to achieve even greater transparency, the Panel further suggests that TNC consider whether to publicly disclose the actual prices paid and received by TNC in transactions involving government entities.

The Panel believes that the Memo properly articulates the specifics of TNC's "No Net Profit" policy, and explains how to calculate the sales price in order to comply with that policy.

E. Compatible Human Use

TNC has long recognized that conservation of biodiversity must allow for a reasonable amount of human use of conservation lands. It is important that TNC be able to demonstrate that

[2] The Panel agrees with the recognition in the Memo (at p. 12) that "having a sound Conflict of Interest Policy will help The Nature Conservancy comply with the Standards for Charity Accountability established by the BBB Wise Giving Alliance, with Internal Revenue Service rules against private inurement and private benefit, and with state statutes addressing conflict transactions."

it is consistently following a policy of allowing only those human uses that are compatible with TNC's conservation goals and adhere to it.

In this regard, at the June 13, 2003 Board of Governors meeting, the Board affirmed that human use on TNC preserves may occur in four circumstances:

- The activity has little predicted impact and poses no identified threat to TNC's conservation targets;

- The activity has limited predicted impact but has an educational or other value that outweighs the predicted impact;

- The activity is part of a strategy to reduce or eliminate threats to conservation targets or is designed to mimic or restore essential ecological processes; or

- The activity contributes significantly to learning and demonstration opportunities for compatible use and biological diversity preservation when weighed against potential impacts.

The Board also (i) resolved that TNC will not initiate new oil and gas drilling or mining of hard rock minerals on TNC preserves unless already required by existing contracts; and (ii) organized a team of Board members and independent ecologists and economists to advise on human use activities. The team of Board members, ecologists and economists submitted a report to the Board in October 2003, focusing on the need for a greater scientific understanding of the impacts of proposed human uses and their financial implications. The report also addressed issues regarding appropriate levels of decision making and governance with respect to human use activities.

The Panel believes that the Board's articulation of TNC's compatible human use policy on June 13, 2003 is appropriate. In addition, the Panel agrees with the recommendation in the Memo that a committee composed of senior staff be formed to review "innovative, large scale, or untested proposed human uses." The Panel would also suggest that any proposed transactions approved by this committee be presented to the newly-formed Conservation Project Review Committee for final approval. For purposes of transparency, the Panel recommends that TNC also include an explanation of its compatible human use policy, with examples, in its Form 990.

F. Executive Compensation

In recent years, executive compensation at for-profit organizations has come under intense scrutiny. If anything, this issue is even more sensitive in the context of not-for-profit organizations. Both for purposes of public perception and for maintaining its tax-exempt status, TNC should maintain a consistent policy of paying executives amounts comparable with those paid by other similar not-for-profit organizations. It is especially important that the Governance Committee play an active and independent role in reviewing the performance and setting the compensation of the President, as well as reviewing and approving the compensation of senior staff positions; and the compensation of the President and senior staff should be disclosed in great detail in the Form 990. Any compensation consultant retained by TNC should be chosen by the Committee.

The Panel could not agree more with the statement in the Memo (at p. 5) that "it is important to ensure that TNC has a well-structured and transparent policy toward determining compensation levels for its senior executives." Accordingly, the Panel recommends that the EC adopt the suggestions of the TNC Compensation Working Group (outlined on pp. 5-6 of the Memo) with respect to the manner in which the new Governance Committee should oversee matters of senior management compensation.

G. Lobbying

In order to maintain its tax-exempt status, section 501(c)(3) organizations such as TNC are required under the Internal Revenue Code to limit their lobbying activities to less than a "substantial part" of their overall operations. In this regard, as noted in the Memo, the TNC Board of Governors has approved an expenditure of up to only two percent of TNC's charitable budget on lobbying activities. The Panel believes that this threshold is more than consistent with the letter and spirit of IRS policies.

H. Compliance

The Panel's recommendation that TNC hire a permanent Compliance Director was adopted by the Board at the January 29, 2004 meeting, and the Memo properly articulates the responsibilities attendant to such a position.

Unlike the Internal Auditor whose function would be to review past events and transactions, the Compliance Director would essentially operate on a going-forward basis. The Compliance Director would implement programs to ensure that TNC operates in accordance with the law and its policies, and would review specific transactions and events as they transpire for adherence to the law and TNC policies. By contrast, the Internal Auditor's role would be to review completed transactions and events, in addition to duties such as those of an inspector general in a government agency, which also involve the review of completed transactions and events.

In the Memo (at p. 8), senior staff has suggested that the Compliance Director be housed in the office of TNC's General Counsel, and report to both the General Counsel and the Audit Committee. As set forth in the Panel's Board Proposal, the Panel recommends that the Compliance Director report directly to the EC as well as to the President. In addition, while the Panel recognizes that the costs of establishing the new position of Compliance Director will be significant, the Panel does not believe the Compliance Working Group should specify in advance that the Compliance Director should have no additional direct reports other than an administrative assistant. The Panel recommends that the Compliance Director be recruited from outside TNC.

I. Reputation and Transparency

In addition to the recommendations made above with respect to individual issues, the Panel has observations involving generic questions of reputation and transparency. The first concerns establishing mechanisms to review conservation projects before committing to them in order to ensure that they not only meet TNC's conservation objectives and comport with its policies, but do not raise issues of compliance or reputational risk. The second concerns using TNC's IRS Form 990 as a voluntary disclosure device in order to promote transparency.

(1) Conservation Project and Activity Review

The Panel's Proposal in Part I recommended the creation of a Conservation Project Review Committee of the EC to ensure adequate oversight and risk management of TNC's conservation programs, with a particular focus on large or novel conservation projects. For example, the Conservation Project Review Committee would closely examine high-dollar value conservation buyer transactions and transactions with government entities, as well as proposed compatible human use activities. The Panel believes as does the BOG that such EC level review is essential to protect TNC's reputation, assure legal compliance, and serve the organization's conservation objectives.

The Memo proposes to augment the work of this Committee by creating processes for managing risk at the staff level (Memo at pp. 33-36), including the proposed creation of a staff level committee to oversee such processes (which committee itself would report to the Conservation Project Review Committee). The Panel agrees with this approach which should go a long way toward achieving this end and preventing any single project from damaging TNC's reputation.

(2) TNC's Form 990

The Panel believes that the Form 990, which the Internal Revenue Service requires all non-profits to file annually, provides an opportunity for transparency and disclosure. Although the Form 990 does not require disclosure as detailed as that required in annual reports filed by public companies with the Securities and Exchange Commission, it can serve as a non-profit's version of what is now required by Sarbanes-Oxley for public companies. Therefore, the Panel suggests that TNC voluntarily disclose as much as possible (about its mission, policies, programs, goals, etc.) in its annual Form 990 in order to keep donors, the public, and interested governmental entities well informed about its activities. The Panel suggests that the changes and initiatives implemented since the June 13, 2003 BOG meeting be discussed in TNC's next Form 990, and that thereafter each Form 990 should include a report on the work of the Conservation Project Review Committee during the prior year.

The Panel observes that the Form 990 filed by Memorial Sloan-Kettering serves as an example of a model Form 990.

Simply put, TNC could use its Form 990, in the words of one commentator, "to detail the activities, experiences, and ethical record of the organization during the previous year."

Appendix A: Work of Outside Advisors on Key Issues

August 20, 2003

The Nature Conservancy aspires to set a standard for best practices for a highly-decentralized, global non-profit organization, committed to a culture of innovation through competent risk taking. While confident that TNC has the right values and strategy to serve its mission, the Board is constantly seeking to improve and enhance its governance, transparency, and accountability. Therefore, the Board decided at its meeting on June 13, 2003 to enlist outside perspective and expertise to help in these areas. This memo will further define this work.

The objective of the work with independent advisors will be to provide the Board of Governors of TNC with a set of forward-looking recommendations on key issues facing the organization in the areas of governance, transparency, and accountability.

The outside advisors will be given latitude in determining the scope of their work with the caveat that we are not looking for an evaluation of the past but rather advice on how to move forward in the areas of governance, transparency, and accountability. This Governance Advisory Panel will be chartered by the Board of Governors and the group will deliver the recommendations to the Board and keep the Board informed throughout the group's process. The Panel will have the opportunity to make recommendations related to other issues discussed at the June 13 Board meeting but its focus will be on questions that were not addressed or remain unresolved after that session. These outside advisors will not be staff or Board members of TNC. The outside advisors will be asked to serve pro bono, however they will be reimbursed for their expenses. A final report of the Panel's recommendations will be made available to the public.

The group will include up to seven individuals with diverse and broad experience in the issues of governance, both in the for-profit and non-profit arenas. These individuals will have a reputation for integrity and a commitment to conservation. The Panel will be fully supported by professional staff hired for this purpose. TNC will raise funding to cover the costs of this staff.

The Panel will make an interim report to the TNC Board at its meeting in January. It is anticipated that final recommendations will be made by March, 2004. The advisors will be asked to develop answers to a series of questions. These questions are drawn from the discussion of the Board of Governors at the June 13 Board meeting. The questions are in the following areas.

Governance

The Board would like the outside advisors to provide their advice on how the Board ensures that we use our governance processes to achieve the highest levels of integrity throughout the organization. Some questions the advisors might choose to address are:

- How can the Conservancy's governance approach better ensure that it achieves its foremost value - integrity beyond reproach?

- What types of backgrounds and experiences should be reflected on the Board of Governors and in what proportion to the total Board membership? How many members should the Board have? Should there be any other entities created (i.e. advisory councils) to help the Board do its work?

- What is the optimal committee structure arrangement and what should be the charges to those committees?

- How should issues be identified for Board consideration and review?

- How should potential Board members be identified?

- How does the Board ensure that our procedures are designed and executed so as to support the policies established by the Board?

Transparency

We would like the advisors to give us their opinion on the meaning of transparency in the non-profit sector and how to apply this perspective within the context of TNC. Some questions the advisors might choose to address are:

- What can TNC do to reach its desired standard of becoming a model of transparency in the non-profit sector?

- What categories of information should be easily available to all the constituencies that are important to TNC?

- How do we ensure there is no gap between how we describe ourselves and who we really are?

Accountability

We are seeking assistance in thinking about the issue of accountability. To what constituencies are we accountable and how are we accountable? Other questions the advisors might provide an opinion on are:

- What are the key areas in which the Board of Governors needs to step up its oversight of TNC activities in order to minimize risk to the organization?

- What benchmarks should the Board establish to monitor the organization's performance?

- What role should members, donors, and partners play in evaluating TNC's effectiveness?

Appendix B: Draft Audit Committee Charter

As New York State Assistant Attorney General William Josephson has noted, in today's world the Audit Committee is the sine qua non of a non-profit. The Panel agrees, has emphasized the importance of the Audit Committee in Part I of this Report, and has also prepared the following draft charter for the EC's consideration.

Purposes

The Audit Committee will assist the BOG and the EC in fulfilling its oversight responsibilities by monitoring (1) the overall systems of internal control and risk mitigation; (2) the integrity of the financial statements of TNC; (3) compliance by TNC with legal and regulatory requirements and ethical standards; and (4) the independence and performance of TNC's internal and independent auditors.

Membership and Meetings

Committee members shall have a basic understanding of finance, accounting and fundamental financial statements, and at least one member of the Committee shall be a financial expert as determined by the EC.

The Committee shall meet quarterly with the internal auditor and twice each year with the independent auditor in separate executive sessions to provide the opportunity for full and frank discussion without members of senior management present.

Authority

The Committee's role is one of oversight. TNC's management is responsible for preparing TNC's financial statements and the independent auditors are responsible for auditing those financial statements. The Committee recognizes that TNC's management, the internal audit staff and the independent auditors have more time, knowledge, and detailed information about TNC than do the Committee members. Consequently, in carrying out its oversight responsibilities, the Committee is not providing any expert or special assurance as to TNC's financial statements or any professional certification as to the independent auditor's work.

The Committee shall have the power to conduct or authorize investigations into any matters within the Committee's scope of responsibilities, with access to all books, records, facilities and personnel of TNC. The Committee shall have the power to retain special legal, accounting, or other consultants to assist in the conduct of such investigations or to advise the Committee, at TNC's expense and without further BOG or EC approval.

The Committee may request any person, including but not limited to any officer or employee of TNC or the independent auditor, to attend Committee meetings or to meet with any members of, or advisors to, the Committee.

Responsibilities

The Committee shall undertake the following responsibilities, which are set forth as a guide. The Committee is authorized to carry out these activities and other actions reasonably related to the Committee's purposes or assigned by the BOG or EC from time to time.

Internal and Independent Audits

Internal Audit

- Recommend the appointment, compensation, performance evaluation and replacement of the Director of Internal Audit, who shall report functionally to the Audit Committee;

- Review the risk assessment that drives the internal audit plan and annually approve the plan;

- Review the activities of the internal audit function; and

- Review the effectiveness of the internal audit function including staffing.

Independent Audit

- Recommend the appointment of the independent auditor, and evaluate, compensate, and oversee the work of, and if appropriate terminate, the independent auditor, who shall report directly to the Committee;

- Review and approve the terms of the independent auditor's retention, engagement, and scope of the annual audit, and pre-approve any audit–related and permitted non-audit services (including the fees and terms thereof) to be provided by the independent auditor;

- Review and confirm the independence of the independent auditor annually by obtaining and reviewing a report from the independent auditor delineating all relationships between the independent auditor and TNC and discussing with the independent auditor any such disclosed relationships and their impact on the independent auditor's independence and by obtaining the auditor's assertion of independence in accordance with professional standards;

- At least annually, review a report from the independent auditor describing the auditing firm's internal quality-control procedures and any material issues raised by the most recent quality-control review of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and

- Review with the independent auditor any problems the auditor has encountered performing the audit and any management letter provided and TNC's response to that letter, and matters that the independent auditor is required to communicate to the Committee.

Internal Control and Risk Mitigation

- Review with management and the independent auditor TNC's major financial risk exposures and evaluate the steps management has taken to monitor and minimize such exposures;

- Monitor the effectiveness of TNC's internal control systems, review, including through regular executive sessions, whether internal control recommendations identified by internal and independent auditors have been implemented by management, review annually the ethics code of TNC and the effectiveness of the procedures established to monitor compliance at every level and ensure through inquiry and other appropriate means that management is communicating the importance of the organization's values, code of conduct and ethics, and internal controls;

- Review adherence to the conflicts of interest and related entities policies, and recommend action as appropriate; and

- Establish procedures for receiving, retaining and treating complaints received by TNC regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of TNC regarding questionable accounting or auditing matters.

Financial Reporting

General

- Review with the independent auditor significant accounting and reporting issues, and alternatives, including recent professional and regulatory pronouncements, understand their impact on the financial statements and ensure that all such issues have been considered in the preparation of the financial statements; and

- Review with the general counsel, management and the independent auditor, including in separate executive sessions, key functional activities of TNC, including legal, tax, or regulatory matters that may have a material impact on the financial statements and any material reports or inquiries received from regulators or government agencies.

Annual Financial Statements

- Review with management and the independent auditor any complex and/or unusual transactions;

- Review with management and the independent auditor, including in separate executive sessions, issues related to judgments made involving valuation of assets and liabilities and commitments and contingencies;

- Review with management and the independent auditor, in separate executive sessions, the annual financial statements and the results of the audit;
- Review with management the annual audit report and recommendations of the independent auditor, including any audit problems or difficulties and management's response; and

- Meet annually with management and the external paid tax preparer to review any issues or judgmental areas relating to the disclosures in TNC's IRS forms.

Compliance with Laws, Regulations, Ethics, and Policies

- Conduct an annual review of TNC's compliance with law, and with its ethical standards and policies;

- Review with management, including the General Counsel and Compliance Director, all legal and ethical compliance issues;

- Oversee the functions of the Compliance Director;

- Act on findings of the Compliance Director with respect to issues of non-compliance;

- Review with management and the independent auditor, including in separate executive sessions, the findings of any examinations by regulatory agencies; and

- Review with the internal auditors any possible areas of noncompliance with laws and ensure that management follows up with relevant procedures where appropriate.

Conflict of Interest

- Review, with the General Counsel and Compliance Director, all issues of conflict of interest;

- Coordinate, with the Conservation Project Review Committee, the resolution of conflict of interest issues with respect to conservation projects; and

- Oversee compliance with TNC's conflict of interest policy.

Other Responsibilities

- Ensure that significant findings and recommendations made by the internal and independent auditors are received and addressed by management on a timely basis;

- Annually review and update the Committee’s charter, as needed;
- Conduct an annual performance evaluation of the Committee and make any changes to the Committee’s composition or function necessary to address areas of improvement revealed in the evaluation; and
- Maintain minutes of meetings and periodically report Committee actions and make such recommendations as the Committee deems appropriate.

Appendix C: Curricula Vitae of Governance Advisory Panel Members

Ira M. Millstein (Chair): Mr. Millstein is a senior partner of Weil, Gotshal & Manges LLP, an international law firm based in New York City. He has counseled numerous high-profile publicly-held corporate boards and state and private philanthropic boards on issues of corporate governance. He is the Honorary Chairman of the Board of Advisors of the International Institute for Corporate Governance at the Yale School of Management and a Professor at the Yale School of Management. He is an elected member of the American Academy of Arts and Sciences and author of books and articles on Corporate Governance.

Derek C. Bok: Mr. Bok, a former president of Harvard University and Dean of the Harvard School of Law, now serves Harvard as the Chair of the Hauser Center for the study of nonprofit organizations and philanthropy. He is the author of numerous books on higher education, government, and executive and professional compensation.

Claudine B. Malone: Ms. Malone is President of Financial and Management Consulting, Inc. She serves or has served on the Boards of several large companies, non-profit organizations, and academic institutions. She is a former chairman of the Federal Reserve Bank of Richmond.

Richard T. Schlosberg III: Mr. Schlosberg is the immediate past president and CEO of the David and Lucile Packard Foundation, a position he held since May 1999. Prior to joining the foundation, he served 23 years in the communications business and was publisher and chief executive officer of the Los Angeles Times and executive vice president of The Times Mirror Company.

Thomas J. Tierney: Mr. Tierney is the former chief executive of Bain & Company, an international consulting firm, recognized as one of the premier strategy consulting firms in the world. He is also the founder and Chairman of The Bridgespan Group, an independent, non-profit affiliate of Bain & Company designed to provide high-quality consulting services to foundations and non-profit organizations. He serves on the boards of several non-profit organizations and co-authored <u>Aligning the Stars</u>, an organization and leadership book published by the Harvard Business School Press in 2002.